INTEREST ON INVESTMENT AS A MANUFACTURING COST FACTOR—DISCUSSION

Lewis H. Haney.—1. *Argument based on assumed identity between economic and business costs.*—Mr. Scovell's first argument may be stated to be "the argument based upon an assumed identity of economic cost and business cost." The two concepts, however, are very different, and cannot be made the same. The accountant deals with a particular business concern. He takes what to the economist is a short-time point of view. He is concerned with the financial results of the particular concern. To the accountant price equals cost plus profit. The economist, on the other hand, deals with a whole society; he does not even confine his attention to business, let alone a single business concern. He is concerned with long periods of time. Financial results only interest him indirectly, as his ultimate interest is in wants and sacrifices. In economics price equals cost,—even profits is regarded as a share in distribution which the entrepreneur must have.

Mr. Scovell says that if the management provides its own capital, the "economic cost is no less than if others provided it." This statement is absolutely true; but it concerns economic cost only. The question at issue is accounting cost. The sacrifices of saving and waiting are present; but is there any interest or investment in the particular case with which the accountant happens to be dealing? As a matter of fact, no interest at all may be earned. If there is any interest it is not an expense to anyone, but is income to the owner.

2. *Arguments based on analogy between interest and other shares in distribution.*—Mr. Scovell, in his paper, states that there is a "cost" (sic) for the "use or service" of capital, just the same as for labor or land. But the capitalist owner does not pay for the use of his own capital, while he does incur actual expense for hired labor and land; and I maintain that the fact that there is actual outgo in the latter case makes a difference which for the accountant is fundamental.

Another difference lies in the fact that if he did not pay his hired laborers their wages, they would stop the works; while no such result would follow if his accountant should not enter an interest charge on the books. My point is merely that these things constitute a difference, and controvert the argument from analogy.

Especial reference is made to the analogy betwen interest and rent. On this point I do not concede that interest and rent are the same. Land is different from capital; it is a non-fungible element which is not

fused in the plant and equipment account as is capital, but remains separate and liable for specific delivery. This fact finds expression in the further fact that the rent contract calls for an actual outgo that is entirely independent of the net earnings of the business, which is not true in the case of interest. The case of a tenant farmer is referred to; and it is inferred that, because he pays rent, which is to him a cost, therefore interest is a cost. Now in the first place, it is to be noted that rent is not a cost in economics, and that the analogy between economic cost and accounting cost falls to the ground in this regard. But the point I would make is that the rent is actually paid out, by the tenant, and must be paid before the net earnings of the business can be known. Furthermore, the difference between money rent and share rent illustrates my point. If money rent is referred to, the rent payment presumably represents outgo to a completely separate owner, who stands in a sense opposed to the farm business; and accordingly the rent is cost to the business. If, however, share rent is referred to, the amount of the rent depends in part, at least, upon the net earnings of the business. Therefore, the farm owner is not entirely separate from the business of the tenant, and rent and profit can not be separated.

Mr. Scovell states that if a tenant buys his farm and becomes an owner, the costs of production remain unchanged; but here I would point out that he is again shifting from accounting cost to economic cost. It is economic rent which remains the same, and would remain the same even if the first owner had given the tenant the *use* of the farm rent free. Furthermore, please note that rent as an outgo from the business does cease when the owner and the former become the same person. It may be asked, "Does it cost the owner any less than the tenant to produce the same crop?" Other things being equal, the owner does pay out less. He has smaller outgo to account for on his books, and does this not mean a lower "accounting cost"? The economic cost, however, is actually greater, by the amount of the sacrifices involved in saving the capital invested in the farm. In fact, under competition, the economic cost of the capital invested in the farm just balances the capitalized rent which the tenant formerly paid. The *income* of the owner is greater than that of the tenant. This may be explained in either of two ways: (1) the owner's greater income is a reward to cover the costs involved in the investment; or (2) it may be said that his income is greater because as owner he does not have to pay the rent which was an outgo cost to his as tenant. The two ways of looking at the matter are reciprocal.

Let us examine the method which Mr. Scovell recommends for making "interest on investment" look plausible on the books as cost. It is proposed to take the following steps:

1. Take the *value* of assets as the basis.
2. Calculate interest thereon at some rate not stated.
3. Devise charges for interest which will spread this estimated interest on investment over the various parts of the investment, making "charges" for rent, equipment, inventories, etc.
4. Offset these charges by setting up an account called "Interest Charged to Cost" (but which is really "Accrued Interest estimated to be earned in the Business"), to which account the charges are credited.
5. Close this interest account into Profit and Loss, the amount being available for dividends "if not offset by losses."

To me this scheme looks like a subterfuge. The end is clearly to get some interest into the Profit and Loss account where it will be available for dividends. Are dividends, then, interest? It would result in making some interest seem to be earned by merely crediting income with an estimated amount and justifying that amount by charging it to cost.

In reality, a part of the time called interest is profits.

But little is said in the paper under discussion of the analogy between interest and profits. Did time permit, I would point that in economic analysis price must cover profits, while in accounting profits depends upon price. I will merely state, however, that much of the argument advanced for including interest in cost would apply to profits. It may equally well be stated that profits is "cost" for the use or service of the business enterpriser; or that profits have to be received if the business is to be "worth while."

I conclude that interest on investment and profits are inseparable *in accounting*. In economic theory the two are separate. But as long as capitalist-owner and entrepreneur functions are so intertwined as they are in the business world, the returns to the two can not be divided as items of expense. In fact, bond interest is partly profits, and dividends are partly interest. The net earnings of the owner-entrepreneur are a mixture of interest on investment and profits on enterprise.

3. *Argument based on "opportunity cost."*—Mr. Scovell states that "if the net profit resulting from trading does not exceed the amount which the capital might earn invested in standard bonds, yielding ordinary rates of interest, then from an investment point of view, the business is not worth while." Note the "opportunity cost" idea which is here presented. The argument is that interest is cost, because the capitalist-owner might have got interest if he had invested his capital

in some other business. The poet says that the saddest words are: "It might have been." And accordingly I would dub this concept of cost the "sad words cost." It is only necessary to call attention to the fact that the accountant is concerned, not with what might have been, but with what is. If the business, whose life history is recorded, is a failure, and does not even earn interest, no amount of modern cost accounting work can change the situation. Interest has not been earned; has not been paid; and cannot be paid. If every business man were to enter on his books as costs the sums which he might have made, we would have an impossible situation.

4. *Argument based on general productivity of capital.*—Mr. Scovell confuses capital in general with the particular capital invested in a particular business. It is true that the economic factor, capital, must and does receive interest. It does not follow, however, that the capital invested in every business must or does receive interest.

The fundamental error in Mr. Scovell's paper is his assumption of some rate of interest which all capital ought to have and which ought to be allowed for the "use" of any and all capital. The rate of interest is something which is not to be taken for granted; and interest is not earned by all capital goods. The interest rate has to be determined by demand and supply forces; and what rate will apply to any particular business can only be known after interest has been earned. The assumption that capital in a given business might have earned 3 per cent, or any other per cent, in some other use, is gratuitous. Indeed, if all capital were to seek investment, even in government bonds, it would go begging.

5. *Arguments based on policy.*—A chief point made in the paper is that it is desirable to include interest in cost as a matter of business policy. This point, of course, might be dismissed with the statement that we are not concerned with policy, but with fundamental principles and truth.

This matter of business policy raises the question in my mind as to what the motive is for the movement towards including interest in cost. Doubtless the motive is in part to educate irresponsible business men, the idea being to prevent unreasonable price cutting and to establish a wise selling policy. As Mr. Scovell says, the inclusion of interest on investment in cost is an important factor in determining the manufacturing and selling policy. This motive may be commendable and socially unobjectionable. It is to be noted, however, that this by no means constitutes an argument for putting interest into cost. To obtain the end desired, it is only necessary that some estimate of in-

terest be made and that the business man make bargains with some regard to that estimate. At the end of the fiscal period, the net earnings will show what interest and profits have been earned.

Again, it may be desired to figure in advance what prices will have to be secured in order to warrant the use of certain estimates for comparative purposes, and some good may come therefrom, although I am inclined to think that the results would tend to mislead, rather than give correct information, and certainly might do so.

Or the aspiration may be to square the circle and to harmonize economics and accounting. This, however, is impossible. There need be no conflict or inconsistency between the two any more than there is between the society and individuals. But the two are by nature different. And economic cost and accounting cost cannot be made identical.

Other motives exist, however, which are more sinister. During the last few years, there has been a general tendency in the business world to eliminate competition in price. We have had an organized propaganda for the maintenance of resale prices on manufactured articles; we have had a movement to allow the value of raw materials from property owned by the producer to go into cost, by charging depletion and depreciation, not on a cost basis, but on a value basis. We find many accountants standing for the value of the investment, as a basis for price fixing, etc. And Mr. Scovell, I judge from his paper, would stand with such accountants. Also the portentous growth of associations in all industries is a well-known phenomenon; and these associations generally center in the idea of what is called "uniform systems of cost accounting," a phrase which may mean systems of uniform costs. Now comes an effort to put a fixed return on investment into cost. Where will it all end?

Are we to reach some advanced economic stage in which the "industrial engineers' " art will enable the tired business man to sell "at cost" and still receive a return on his investment?

6. *Government authority.*—With regard to Mr. Scovell's reference to the Federal Trade Commission, I can only say that the quotations presented merely indicate that to a limited extent, for comparative purposes, the Commission indicated that interest and rent might be "considered." The pamphlet quoted does not state that interest is cost.

I would further call attention to the fact that in all its numerous reports made to the Price-Fixing Committee, the Commission has excluded interest from cost. I cannot but feel that Mr. Scovell has gone too far in citing the Federal Trade Commission as a sponsor for the idea which he is defending.

Summary.—The gist of my remarks may be summed up as follows: It is fundamental to recognize the impossibility of making the accounts for a particular business square with the distribution of the social dividend. In a word, social economics differs fundamentally from private business.

With this general background, my reasoning is as follows: Interest may in a sense be called cost by the business man; but in any case it is very different from outgo cost for wages, material, depreciation, and the like. The question is therefore one of wise definition, my conclusion being that it would be unwise so to define cost as to include interest.

1. Interest is not cost in the economic sense.

2. Interest may be cost in the private acquisitive sense and might be treated as cost by an accountant. But if "interest on investment" is so treated it would be but a hypothetical book entry which would be liable to abuse. There is no general assumption to be made that interest will be earned in all cases. It may not be earned at all; it may be earned on a part of the investment; or a very low rate only may be earned on the entire investment. In any case it is practically impossible to separate interest and profits.

3. To be used in real accounting costs, therefore, interest must represent actual outgo.

4. The outgo must be real; that is, it must represent payment to parties not connected with the business and must be independent of the net earnings. If interest is actually paid, and is paid for the use of capital, the owner of which is absolutely dissociated from the business—that is, if he is a mere capitalist—then that interest payment may be regarded as true cost.

No objection is to be made to the estimation of interest for comparative purposes; but such estimate should be recognized as being hypothetical and not outgo cost, and as having no significance as determining competitive prices.